



COUNCILMEMBER DONNA FRYE

City of San Diego

Sixth District

MEMORANDUM

DATE: October 5, 2004

TO: Honorable Mayor and City Councilmembers
City Manager, P. Lamont Ewell
City Attorney, Casey Gwinn

FROM: Councilmember Donna Frye

SUBJECT: October 4, 2004 Memorandum from Diann Shipione, SDCERS Trustee

Please see attached memorandum from San Diego City Employees' Retirement System (SDCERS) Trustee Diann Shipione regarding her opposition to certain recommendations contained in council agenda item 330, for October 5, 2004, City Manager's Report No. 04-218 dated September 30, 2004, "City Manager's Recommended Action Plan and Initial Analysis Related to the Recommendations in the Pension Reform Committee's Final Report."

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SDCERS
San Diego City Employees'
Retirement System

MEMORANDUM

DATE: October 4, 2004

TO: Honorable Mayor and Council

FROM: Diann Shipione, Trustee

SUBJECT: Opposition To Certain Recommendations Contained In Council Agenda
Item 330, For October 5, 2004, City Manager's Report No. 04-218 dated
September 30, 2004, "City Manager's Recommended Action Plan and Initial
Analysis Related to the Recommendations in the Pension Reform
Committee's Final Report" ¹

RECOMMENDATIONS CONTAINED IN MANAGER'S REPORT NO. 04-218 SUPPORT
CONTINUED INTENTIONAL UNDERFUNDING OF THE PENSION PLAN BY THE
CITY OF SAN DIEGO UNTIL AFTER FISCAL YEAR 2008.

THIS IS A "FORMULA FOR INSOLVENCY" THAT BACK-LOADS TO 2009
A MULTIBILLION-DOLLAR BALLOON PAYMENT AND CORRESPONDING ANNUAL
CONTRIBUTIONS IN THE HUNDREDS OF MILLIONS OF DOLLARS

**The City of San Diego will default on its annual required contribution for its pension plan
if it follows the Manager's recommendations.**

There is *not one* recommendation in the City Manager's Report that requires the City to immediately begin to fully fund its annual required contribution as calculated using the actuarial assumptions recommended by best practices.

And, there is no legal basis for the City of San Diego to continue to intentionally underfund this pension plan.

The City must pay for the benefits it promises or it must reduce the benefits. Otherwise the City will face a "Retirement Tax", a financial restructuring or worse.

¹The City Manager Report was not available until late afternoon on Thursday September 30th, 2004 to be discussed 4 days later, on Tuesday, October 5th providing little time for a member of the general public with a full-time job to produce a written response. As a result, there may be additional information on this issue submitted at a future date.

The City has most recently, and again, underfunded the City retiree pension plan by contributing only \$130 million on July 1st. This amount was grossly deficient ². The City will also be in default on the contribution required for its pension plan in fiscal 2004-05.

In an October 3, 2004 *San Diego Union Tribune* interview Mayor Dick Murphy admitted the City's plan is to continue to intentionally underfund its pension until after FY 2008 stating: ***"First of all, we have to get to the position where the contributions that the city's making cover the costs. Under the plan we have in place, that is unlikely to happen before July 1, 2008. As part of our settlement in the lawsuit brought by the pensioners, we've agreed to make full actuarial payments in fiscal year '06, fiscal year '07, fiscal year '08. But it is not clear that that would actually pay the full cost to the system."*** ³

What the Mayor means by this is the calculations of contributions for the period now until after FY 2008 will be cooked to create a number that understates the real amount owed by the City to the plan. (This is why Prop G is a bad deal and the continuation of an illegal practice.)

The San Diego City Employees' Retirement System's (SDCERS) outside auditor, Mercer, warned in its recent audit report ⁴, that if contribution rates are below full funding of actuarially determined contributions using recommended best practice assumptions it "...increases the unfunded actuarial accrued liability and future contribution requirements unless there are sufficient gains to offset this loss. The full funding of actuarially determined contributions is considered a best practice because it creates a more stable funding environment and avoids pushing contributions onto future generations."

The Mayor's Pension Reform Committee (PRC) cautioned that the \$130 million payment made July 1, 2004 would be grossly insufficient. The Committee recommended a minimum of \$259 million was required just to keep from "going backwards" and \$307 million was required to fully fund. ⁵ As staggering as these numbers from the PRC appear, they are still low! This is due to the use of certain actuarial assumptions such as a 5% "medflation" rate for the retiree health care benefit that even the City's own outside attorneys, Vinson & Elkins ⁶, acknowledge is "highly optimistic in light of its history of significantly exceeding this rate." ⁷

² Note that \$15 million was removed from the \$130 million to partially pay for the retiree health care benefit.

³ *San Diego Union Tribune*, Interview, October 3, 2004.

⁴ *Mercer Audit of Actuarial Work, San Diego City Employees Retirement System*, May 11, 2004, page 6.

⁵ PRC presentation to City Council September 21, 2004, \$259 million included: \$122 million Normal Cost including Retiree Health, \$93 million in interest on pension deficit, \$44 million in interest on retiree health. \$307 million included all of the above plus \$33 million in amortization of pension UAAL and \$14 million in amortization for retiree health UAAL (both using 15 year amortization schedule).

⁶ *Report On Investigation, City of San Diego, California's Disclosures of Obligation to Fund the San Diego City Employees' Retirement System and Related Disclosure Practices, 1996-2004, With Recommended Procedures and Changes to the Municipal Code*, September 16, 2004, Paul S. Maco & Richard C. Sauer, Vinson & Elkins, L.L.P., Washington, D.C.

Vinson & Elkins also advises on page 32 of their report, "***A pension system derives its ability to pay benefits from three sources: employer contributions, employee contributions and earnings generated from such contributions when retained within the system and productively invested.***" (Emphasis added). On page 28 they warn that the funding arrangements used since 1996 by the City under Manager's Proposal's 1 & 2, "...were **below the rates determined by the actuary during this period as necessary to cover the annual costs of the City's plan (i.e., the actuarially required rates ("ARC"))**." and on page 5 they also note that, "***...the City took advantage of certain vagaries of "actuarial science" and pension accounting to further minimize its contributions to SDCERS.***" (Emphasis added).

SDCERS has received legal advice from several outside attorneys that cite multiple relevant court decisions to support the vested right of public retirement system members to a retirement program **that is soundly funded**. The courts have stated that disruption of annual installments of reserves for other competing budget demands is an invasion of the trust's reserve that impairs the employee's right to sound funding and that a key element of the operation of a retirement system is to ensure the financial integrity and security of the system. In the *Wilson* case⁸ the court thoroughly reviewed the employer's obligation to fund a retirement system on an actuarially sound basis and substantially strengthened the law with respect to funding. Here are some of the excerpts:

"There is a vested right to 'integrity and security in the course of funding for the payment of benefits.'" 52 Cal.App.4th at 1136, quoting from *Vales*, 139 Cal. app.3d at 785.

"The willingness and ability of the sponsor of a defined benefit pension plan is to maintain this 'orderly schedule' [of contributions well in advance of benefit requirements] is the major factor in the assurance of benefit security for retirees..." 52 Cal.App.4th 1139 quoting from the declaration of the PERS actuary.

"Underpinning both the normal cost calculation and the amortization of the unfunded accrued actuarial liability is an explicit assumption concerning timing of contributions. The importance of timing stems from the fact that **a large portion of a member's benefit is funded by the investment earnings, which are generated by the plan contributions. When monies are contributed later than expected, reduced earnings result – thus creating a shortfall.**" 52 Cal.App.4th at 1140, quoting from the declaration of the PERS actuary. (Emphasis added).

The following City Manager Recommendations constitute a concerted plan by the City to continue to underfund the pension plan and to delay required contributions thus undermining the financial integrity and security of the system.

RE: PRC Recommendation #1: Even if the City adds \$200 million in Pension Obligation Bonds and \$400 million in real estate assets at some time in the future, the City is still underfunding its pension plan. There is no substitute for full funding. The City has no audited financial statements for either

⁷ Ibid, page 102.

⁸ See *Board of Administration v. Wilson*, 52 Cal.App.4th 1109, 1122, 1134, 1136 (1997); *California Teachers Association v. Cory*, 155 Cal. App.3d 494, 507, 508; Hanson Bridget, page 13, 6/12/02 Draft Letter.

Fiscal Year ending June 30, 2003 or Fiscal Year ending June 30, 2004 so there is no reliable information regarding the City's actual revenues, expenses or debt service capacity. In addition, the City and Retirement System have never provided the public or the PRC with the numbers for either the pension deficit or the annual required contribution as calculated using the actuarial assumptions recommended by best practices 9. No legal analysis has been provided to the public that analyzes whether the billion-plus dollar pension deficit is actually a "legal debt" under the Charter and/or State Law that requires a municipality to annually balance its budget. No analysis has been provided to the public that compares the cost of issuing pension obligation bonds to the cost of a Retirement Tax pursuant to Charter Section 76. No public analysis has been provided that certifies as to the total appraised value of unencumbered City real estate. No public analysis has been provided that examines which of these unencumbered properties could be sold to provide cash or a pension contribution, what corresponding decrease, if any, in City lease revenue might occur, or what related fiscal impacts might occur if those properties were sold. The Manager's Report recommends assembling a financing team to issue the POBS. This recommended team includes some of the same individuals, entities, procedures or practices responsible for the previous failed bond transactions. This is particularly remarkable considering the comments in the Vinson & Elkins report. It makes no sense to move forward on issuing bonds without audited financial statements and realistic numbers for the actual pension deficit and annual required contributions calculated with actuarial assumptions based on best practices recommendations.

RE: PRC Recommendations #2 and #3 continue to underfund the pension plan with the creation of Prop G, that allows for continued illegal underfunding until after FY 2008 if the City is making those underfunding payments pursuant to a "lawsuit settlement agreement". There is no legal justification for continuing to underfund this pension plan based on a private settlement. As the Mayor admitted, *"As part of our settlement in the lawsuit brought by the pensioners, we've agreed to make full actuarial payments in fiscal year '06, fiscal year '07, fiscal year '08. But it is not clear that that would actually pay the full cost to the system."* (Emphasis added). 10 In fact, it is clear that these payments will not constitute the full annual contributions calculated according to best practices. Contributions must be made using the annual actuarial valuation and best practice assumptions to ensure the soundness of the system and "generational equity", which as Vinson and Elkins notes on page 5 requires the City, *"to fully fund under the actuarial principal that pension liabilities generated today should be funded today, not passed off onto future generations of taxpayers."* Prop G prevents "generational equity". It allows the continued misuse of "surplus earnings" referred to by Vinson & Elkins as, *"The Snake in the Garden of SDCERS..."* 11 that results *"in the depletion of the system's financial strength"* 12 and

⁹ No analysis has been provided that includes all of the recommended best practice actuarial assumptions such as a lowered assumed rate of return of 7.75%, the inclusion of the Contingent Corbett liability, the inclusion of Administrative expenses, the use of EAN, the use of a 15-year amortization schedule, (and possibly the inclusion of the retiree health insurance liability) pursuant to recommendations from the SDCERS' Actuary, SDCERS independent auditors, and SDCERS independent investment consultant. While some of these assumptions have been analyzed on an individual basis, there has never been an analysis (at least provided publicly) that would include all of these recommended assumptions.

¹⁰ San Diego Union Tribune, Interview 10/3/04.

¹¹ V&E, Report, p. 31.

jeopardizes the "...underlying soundness of the retirement system." ¹³ Rescind prior Council action on Prop G.

RE: PRC Recommendation #4, the City Manager recommends continuing to underfund the pension plan by doing "*further analysis*" on whether to include the "contingent benefits" for funding purposes. These contingent benefits are paid for out of the continued misuse of "surplus earnings", the very problem that Vinson & Elkins refers to as the "*Snake In the Garden of SDCERS*". This dangerous practice depletes the assets of the System. The SDCERS Actuary, SDCERS external auditors of the actuary, SDCERS independent Counsel, and Vinson & Elkins have all considered and analyzed this problem. Siphoning off phantom "earnings" to pay for benefits not actuarially funded continues to undermine the soundness of the system. The 13th Check has been paid this way for over 20 years. The Contingent Corbett benefit has been paid this way since its inception and it actually accrues. The Retiree Health Care Benefit has been paid this way for over 20 years since its inception in the early 1980s. A recommendation to "further study" such long-standing, well-reviewed issues delays the solution. All "contingent" benefits that are paid need to be included in the actuarial computation of total pension liabilities and in the actuarially computed annual funding contribution immediately.

RE: PRC Recommendation #5, the City Manager recommends continuing to intentionally underfund the pension plan by only paying the "balance" of the FY 2005 retiree health care benefits from City funds. The City has already siphoned off \$15 million from the pension system this fiscal year for retiree health care benefits by taking the funds out of the \$130 million that was supposed to partially fund the pension plan. In other words, the City shorted the "celebrated" \$130 million contribution by \$15 million. The City must contribute the full amount of what is owed for the retirement health care, not just the "balance". It must put in the \$15 million it took from the \$130 million pension contribution, and the balance for the retiree health care, and the entire additional amount of the pension contribution it still owes calculated using actuarial assumptions as recommended by best practices. For example, the 5% "medflation" rate assumption used by the PRC to estimate the unfunded liability for Retiree Health was, as Vinson & Elkins notes on page 102, "*highly optimistic in light of its history of significantly exceeding this rate...*" and therefore should be reconsidered.

RE: PRC Recommendations #11, the City Manager recommends delaying action and referring this to the City Auditor and City Attorney for continued work on developing a 115 Trust. Given the comments made about both the Auditor and the City Attorney offices in the Vinson & Elkins report, Council should make a decision now and then hire un-conflicted, independent qualified professionals with expertise in this area to ensure appropriate structures and procedures are created that comply with GASB and United States Internal Revenue Code. If System earnings are going to continue to be used to pay the Retiree Health Care Benefit then the City must fund for it.

RE: PRC Recommendation #12, the City Manager recommends delaying action on this and referring it to the City's Auditor and Independent Auditor. Council should immediately approve the PRC's recommendation to adopt GASB #43 effective July 1, 2005.

RE: PRC Recommendation #13, the City Manager recommends delaying action and referring this to the City Attorney to determine whether current employees have a vested right to retiree health care benefits. Council should insist on receiving the City Attorney's existing opinion regarding

¹² V&E Report, p. 6.

¹³ Ibid.

whether the Retiree Health Care Liability is "vested". In a December 2003 letter, the City Attorney refused to provide me, as a Trustee of SDCERS, a copy of that opinion citing "pending potential litigation." So now the Gleason litigation is over. Release the opinion.

RE: PRC Recommendation #14 was amended and led to Prop H, thus rejecting the PRC's original recommendation. Prop H does nothing to solve the underfunding problem. Rescind prior Council action on the Prop H.

RE: PRC Recommendation #15, the City Manager recommends that Council encourage SDCERS to amend its Board Rules related to the disability retirement determination process. I requested an outside legal opinion regarding the legality of Retirement Board fiduciaries paying an adjudicator to provide an objective opinion. My request has been denied. Council should require an outside legal opinion as to whether the disability retirement determination process currently being employed *and* the one being proposed is legal under California law.

RE: PRC Recommendation #16, the City Manager recommends that a committee be appointed to study this. As was suggested in the May 23, 2002 correspondence to Mayor Murphy, Council should hire an independent national firm with disability expertise to thoroughly audit the SDCERS disability delivery system *immediately*.

RE: PRC Recommendation #17, the City Manager recommends that a committee be appointed to study this. Council should require an outside legal opinion immediately as to the appropriate interpretation of this Charter Section.

In essence, this City Manager's Report does not recommend that full funding occur now; rather that it be deferred to some point in the future. There is *not one* recommendation in this City Manager's Report that requires the City to fully fund its pension plan immediately with annual required contributions calculated using the actuarial assumptions recommended by best practices (ARC).

I have requested the SDCERS actuary of record recalculate the annual required pension contribution and the UAAL for FY ending June 30, 2003 using all of the recommended best practice actuarial assumptions 14. I have also requested the actuary use his recommended best practice actuarial assumptions in the creation of the Annual Actuarial Valuation for FY ending June 30, 2004. Trustees need this information to discharge their duty as governed by the California State Constitution. The City also needs these numbers. After all, the City *promised* the benefits.

The Executive Committee of the Retirement System will be "considering" whether it will allow the actuary to respond to my request. Since the City runs the Retirement System through back door deals, I now request that the City Council, the City Management, the Union Management and the Retirement Board allow the actuary to respond to my request in a timely manner. Failure to do so will bring worse consequences in the future.

¹⁴ Email to Assistant Retirement Administrator Paul Barnett and SDCERS' independent actuary, Rick Roeder dated 9/24/04. Follow up phone call to Rick Roeder on 9/30/04 confirmed he sent a draft letter to Paul Barnett several days earlier. Follow up phone call with Paul Barnett on 9/30/04 confirmed he received Mr. Roeder's letter and would get back to me by Tuesday 10/5/04 at the latest.

The options for solutions to this enormous problem are much more limited now than they were in 2002. What the Council did in 2002 was not a "*mistake*". It was doing the wrong thing for the wrong reason. Please don't do that again by taking action that allows the City to continue to underfund its pension plan. There is no substitute for full funding every year. Get the real numbers, quantify the problem and conform the solution to fix the problem.

CC: KPMG Audit Team
Vinson & Elkins
City Manager Lamont Ewell
SDCERS Board